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THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Keeping Volatility Low with Floating-Rate Assets

CLAYTON TRIICK, CFA, is Portfolio Manager of Angel Oak Capital Advisors. Mr. Triick is the Lead Portfolio Manager for the UltraShort Income Fund and a portfolio manager for the Flexible Income Fund and the Multi-Strategy Income UCITS Fund. He is a portfolio manager within the nonagency and agency residential mortgage-backed securities markets and focuses on cross-asset fund allocation and interest rate risk management of Angel Oak's funds and institutional separately managed accounts. Mr. Triick has been in the investment management industry since 2009 and has experience across multiple sectors of fixed income. Prior to joining Angel Oak in 2011, he worked for YieldQuest Advisors, where he was a member of the investment committee focusing on the interest rate risk, currency risk and commodity exposures of the portfolios alongside directly managing the closed-end fund allocations within the portfolios and individual accounts. Mr. Triick holds a BBA degree in finance from the Farmer School of Business at Miami University in Oxford, Ohio, and holds the Chartered Financial Analyst — CFA — designation.

SECTOR — GENERAL INVESTING

TWST: Can you describe briefly the fund that you manage at Angel Oak?

Mr. Triick: I am one of the portfolio managers on the team who work on various SMAs and funds, including the Angel Oak Multi-Strategy Income Fund, which is our flagship mutual fund; the Multi-Strategy Income UCITS Fund that is under the UCITS guidance globally; and then also the UltraShort Income Fund. The Angel Oak UltraShort Income Fund has a similar strategy to the Multi-Strategy Income Fund, but it focuses on shorter-term investing, ultrashort-type bonds. I am also a PM — portfolio manager — on the Flexible Income Fund, which is mostly focused around corporate credit. We also have private funds and SMAs — separately managed accounts — which I contribute to alongside other portfolio managers here at Angel Oak Capital.

My role tends to be a lot of cross-asset analysis across various structured credit asset classes. This focus encompasses all structured products, including RMBS, CMBS, CLOs and ABS — residential mortgage-backed securities, commercial mortgage-backed securities, collateralized debt obligations, asset-backed securities.

TWST: Because you are a cross-asset analyst, can you give us an outlook for this whole universe and talk about some of the relative pros and cons of those components?

Mr. Triick: Our firm as a whole is really a structured credit asset manager. The firm started in 2008, and we have built out various strategies on the private credit side. We have a private REIT, a couple of private funds and a series of mutual funds that really focus on our best ideas in structured credit for a given mandate. From an outlook standpoint, each area is different. Additionally, depending on where you play within the structured credit space, you can pick your risk tolerance.

Where we really see opportunity right now at this point of the cycle is, the U.S. consumer is very healthy, and the housing market has the most runway. Look at debt-to-income ratios, which are a way to view the current debt of consumers on a per capita basis. Those levels are incredibly low, much lower than they were leading up to the financial crisis, even at levels that we have not seen since the mid-1980s and mid-1990s. So the U.S. consumer is very healthy from a personal balance sheet perspective.

The Millennial generation is only just beginning to step into the U.S. housing market, form households and purchase homes. They have been a huge portion of the rental market as a lot of them have stayed single for longer and formed households later. They are the biggest portion of the growing U.S. economy, and now they are the largest generation in the U.S. economy. With that in mind, we have a significant focus across the private funds and mutual funds that focus on the U.S. consumer and the growing U.S. housing market. Our view is the residential mortgage market will be a very attractive area to invest — from mortgage bonds to private loans, from fix and flip strategies to agency CRT and non-QM mortgage lending.

TWST: Can you choose one of the funds that you manage and maybe go into a little bit more detail about its particular composition?

Mr. Triick: Our flagship fund, the Multi-Strategy Income Fund, just passed $7 billion in assets. Approximately 65% of the assets in that fund are within nonagency residential mortgage-backed securities. Our view is that the U.S. housing market and consumers are much less levered than they were during the financial crisis, especially when you compare that to corporate credit, which has much higher overall leverage ratios, almost reaching the levels that we saw at the peak just before the crisis. We think investing in mortgage-backed, consumer-backed assets is very attractive at this point in the cycle and given the relative leverage points of the underlying assets. What is also very interesting about the legacy RMBS space is that the majority of it is floating rate.

Our positioning as a firm is to continue to have low interest rate risk exposure in this mutual fund. By being able to buy floating-rate mortgage bonds at a discount to par, the interest rate sensitivity is inherently very low. The expected effective maturity on the nonagency portfolio is in the five-to-seven-type range, but the interest rate duration is around two years. A lot of that is driven because of the floating-rate bond allocation.

The remaining allocations within the Multi-Strategy Income Fund are a combination of tactical positions within CLOs, CMBS and ABS, with the majority of these allocations in investment-grade-rated bonds. Almost 50% of those tactical allocations are within AAA-rated tranches. We think these are very interesting areas of structured credit, particularly some tranches of CLOs and CMBS that all provide higher all-in yields than investment-grade corporates but have an A and higher rating. We think structured credit tends to be cheaper than corporate credit from a spread perspective but actually has a higher risk-adjusted total-return profile than investment-grade corporates as a whole.

What continues to be our primary focus in the portfolio is within floating-rate assets that are consumer- and housing-backed. Given this point in the cycle, the yield curve continues to flatten, and the FOMC has not slowed their current interest rate tightening campaign. This increase in funding costs can put pressure on the U.S. economy from a growth perspective, which will also put pressure on traditional fixed income asset classes that have more interest rate sensitivity. Our overall bias to floating-rate assets and consumer- and mortgage-backed assets should keep the volatility of the fund low and keep the NAV stable, even if you see bumps in the road led by the corporate credit sector.

Highlights

Clayton Triick discusses the Multi-Strategy Income Fund and the UltraShort Income Fund. Mr. Triick conducts cross-asset analysis on structured products. At this point in the cycle, Mr. Triick finds mortgage-backed and consumer-backed assets very attractive. His bias toward these and floating-rate assets in the Multi-Strategy Income Fund keep the volatility low and the NAV stable. While the UltraShort Income Fund has a similar strategy to the Multi-Strategy Income Fund, it focuses on short-term investing. The UltraShort Income Fund allocates toward macro market dislocations on the front of the yield curve. According to Mr. Triick, this fund will serve as a source of liquidity by having fewer holdings and more targeted positions.

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TWST: How might the composition of the fund change if interest rates rise more?

Mr. Triick: A few primary factors drive how the Multi-Strategy Income Fund positioning changes in a rising rate environment, the pace of the increase and the volatility it creates. First off, if the U.S. yield curve moves sharply higher, potentially 200 or 300 basis points, this is going to create significant volatility in traditional FI sectors, primarily investment-grade corporates and agency mortgages. Over 90% of the borrowers within agency mortgages are now out of the money to prepay. From that standpoint, rising rates will put a lot of pressure on the agency mortgage market as prices move lower to offset rising rates and mortgage maturities extend as refinancing activity decreases. In that environment, we would look to aggressively be a liquidity provider and source agency mortgage bonds that are priced in the $70 and $80 with positively convex characteristics.

If the overall yield curve continues to move higher but continues to flatten and creates volatility in credit, we would look to various areas of structured credit in RMBS, CMBS and CLOs that have had significant volatility. We would look to remain on the shorter end of the curve, given that the overall yield curve could flatten in the environment and not offer much extra return potential for longer-duration assets. We would focus on shorter-duration but lower-rated tranches as they would be a lot cheaper in that environment.

TWST: When you look out at the universe of your peer group, what strikes you as being your differentiating points as far as your process is concerned? Where do you feel like you are unique in this fund class?

Mr. Triick: First off, Angel Oak as a firm has really built a vertically integrated mortgage credit machine over the last 10 years since its inception in 2008. The firm launched as a mortgage credit private hedge fund to take advantage of the dislocation that was created in legacy mortgage-backed securities. Since that point, the asset management desk has grown significantly. Assets have increased $10 million in 2008 to almost $10 billion in 2018. Simultaneously, the firm has continued to invest in other areas of the company.

Angel Oak as an entity has a few affiliated mortgage companies; thus, we have built a vertically integrated mortgage credit firm whereby we are actually originating a combination of conventional agency mortgages, nonqualified mortgages and small-balance commercial mortgages. From this standpoint, Angel Oak is seeing how the most newly

created mortgages are performing and how the new mortgage market is being contrasted and standardized. Angel Oak is a market leader in the creation of the new nonagency mortgage marketplace.

The ability to analyze how new mortgage programs are performing, what factors drive prepayments and defaults in this environment has been invaluable. Utilizing this data set to allocate growth capital to originate and source nonagency mortgage loans is what drives Angel Oak, the asset manager, as a differentiator in the industry.

TWST: In the UltraShort Income Fund, there are 59 securities. Can you talk about whether you try to keep it to that number, and if so, why?

Mr. Triick: In the newly created UltraShort Income Fund, there are much less individual positions than in the approximately $8 billion Multi-Strategy Income Fund Strategy. The focus of the UltraShort Income Strategy is to allocate toward macro market dislocations that exist on the front of the yield curve. Over the last few decades, we have seen large dislocations that have persisted within investment-grade and high yield corporate sectors. We have seen hundreds of funds launch to focus on fund dislocations in short-term corporate bond management; however, we have seen that disequilibrium go away as the sector gets oversaturated. We see much more attractive opportunities in short-term bond investing within the structured products space.

One of the primary reasons is that as a bond is approaching maturity for a corporation or sovereign, the actual event risk increases as time shortens as it approaches the time to roll or refinance into new debt. This dynamic is quite different in the structured credit space: As a pool of individual auto loans or mortgage loans are getting closer to maturity, credit risk is decreasing as principal is actually being paid off throughout the life of the loan. As that loan or group of loans is approaching maturity, the amount of principal outstanding is much lower. Thus, the loan to value is much lower, and the bonds' event risk actually decreases.

From the fund's perspective, the asset mix is a diversified basket of ABS, RMBS and CMBS with a heightened focus on liquidity. We expect the UltraShort Income Fund will become a source of liquidity for clients on a shorter-term basis to complement their longer-term strategic allocations. We want to have an even higher focus on liquidity for that portion of our fund complex by having a higher portion of cash and high-quality assets. By having fewer holdings and more targeted positions in short-term, high-quality assets, the fund will serve clients better from both a liquidity function and income-driven return perspective.

TWST: In closing, when you look at how you have been managing the funds over the last year, what has most surprised you, whether it is some aspect of the market, the funds' performance or some of the decisions you have made?

Mr. Triick: During the first quarter of 2018, we saw significant volatility in interest rates, stocks and risk assets led by a VIX-led market selloff and tightening monetary policy. What we saw in our markets was quite positive. Within short-term structured credit, both primary and secondary volumes remained on course during those periods of volatility. This is a seismic shift from the pre-crisis era. Structured product resiliency has dramatically improved amidst more money manager adoption of mortgage- and asset-backed credit. Even though this cycle is reaching the latter stages as the Fed is flattening the U.S. yield curve, it has been remarkable to see how well areas of ABS, RMBS and CMBS have performed and the liquidity backbone for these asset classes.

Additionally, 2018 has been marked as the year the interest rate cycle has shifted. The two-year Treasury yield has risen over 140 basis points from a recent low of 1.26% in September 2017 to approximately 2.67% at the end of July 2018. Rising interest rates have been putting pressure on traditional fixed income where the "safer" assets of Treasuries, investment-grade corporates and agency mortgages all have negative price returns in 2018, while floating-rate mortgage bonds and floating-rate CLOs outperform. This is a dynamic we have been noting to our investors would eventually take place as the Fed removes accommodative policies. We do not expect this market trend to end and continue to position in lower-duration sectors with floating-rate coupons to position for continued outperformance over the intermediate term.

TWST: Thank you. (KJL)

CLAYTON TRIICK, CFA
Portfolio Manager
Angel Oak Capital Advisors
One Buckhead Plaza
3060 Peachtree Road NW
Suite 500
Atlanta, GA 30305
(888) 685-2915 — TOLL FREE
www.angeloakcapital.com
email: info@angeloakcapital.com

Basis Point (bps): One hundredth of one percent and is used to denote the percentage change in a financial instrument.
CBOE SPX Volatility Index (VIX): A key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices.
Debt-to-Income Ratio: A financial measure calculated by dividing total recurring monthly debt by gross monthly income.
Duration: Measures a portfolio's sensitivity to changes in interest rates. Generally, the longer the duration, the greater the price change relative to interest rate movements.
Spread: The difference in yield between LIBOR and a debt security with the same maturity but of lesser quality.
Tranche: A portion of debt or structured financing. Each portion, or tranche, is one of several related securities offered at the same time but with different risks, rewards, and maturities.

It is not possible to invest directly in an index.

Diversification does not guarantee a profit or protect from loss in a declining market.

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